

Approaching acquisitions strategically

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Introduction

The literature on the topic of acquisitions and mergers has almost rivalled the level of acquisition activity itself [1]. However, despite the enormous literature on takeovers, relatively little of it has focused on acquisitions from a strategic viewpoint.

Of the acquisitions literature that does deal with strategy, most of it focuses on specific aspects rather than on providing a strategic framework for the whole acquisition process. For example, Malernee and Kirkby address a number of factors including the use of portfolio and industry structure models, and risk return models in diversification [2]; Pekar proposes the use of the business attractiveness/competitive position matrix and describes a range of acquisition options used by Booz Allen and Hamilton [3]; Newton suggests the use of the Directional Policy Matrix as a tool for evaluating acquisitions [4]; and Guineven shows how the PIMS model can be used to evaluate strategic acquisitions [5].

Examination of the articles dealing more broadly with strategy and acquisitions, shows they tend to concentrate on specific steps in the process at the expense of a balanced discussion, are too general, or adopt a checklist or case study approach. Further, virtually all of this literature does not refer to, or attempt to build on, other writers' contributions in this area.

As a result little attention has been directed towards combining the use of

- [1] Baker, H. K., Miller, T. O. and Ramsperger, B. J., 'An Inside Look at Acquisitions and Mergers', *MSU Business Topics*, Winter 1981, pp. 49–57.
- [2] Malernee, J. K. and Kirkby, J., 'Diversification Strategies', in Guth, W. D., *Handbook of Business Strategy*, (Boston: Warren Gorham & Lamont, 1985).
- [3] Pekar, P., 'A Strategic Approach to Diversification', *Journal of Business Strategy*, Vol. 5, No. 4, Spring 1985, pp. 99–104.
- [4] Newton, J. K., 'Acquisitions: A Directional Policy Matrix Approach', *Long Range Planning*, Vol. 14, No. 6, 1981, pp. 51–57.
- [5] Guiniven, J. J., 'Establishing an Acquisition Policy', *European Management Journal*, Vol. 3, No. 2, 1985, pp. 79–84.

strategic models and approaches in an integrated manner to develop a balanced framework to approach the acquisition process. Accordingly the purpose of this article is to undertake this task and provide such a framework to approaching acquisition strategically.

Acquisitions and strategy

Acquisitions are a principal way in which companies grow and expand. Consequently, the strategic implications of them are of considerable importance. However, whilst the decision to acquire another company should be taken within the framework of the acquiring company's overall strategy, this is not always the case. Motives for acquisition are not always strategic in nature. For example, a chief executive's desire to 'empire build', a board's wish to participate in a glamour industry, or an acquisition as a result of an 'expedient opportunity' are sometimes the driving force behind corporate acquisitions.

The result of such acquisitions is, more often than not, unsuccessful from the acquiring company's viewpoint. There now exists an abundant amount of evidence which suggests that many acquiring companies pay too much, both in terms of price and in terms of a subsequent drain on managerial resources, for their acquisitions. Efficient market theory suggests that a company's share price reflects all available information about its performance, activities and future potential. However, frequently the acquiring company has to pay a considerable premium above that which is placed by the market on the company concerned. For example, a recent research study of takeover offers by Austin & Boucher showed the median acquisition premium of the 123 takeover offers analysed was almost 50 per cent above market valuation, and in 16 of the 123 takeover offers the market valuation was exceeded by more than 100 per cent [6]. Prakash points out some companies pay as much as 267 per cent over market value and found the typical premium for acquisitions of \$15 million to be in the range from 50 to 70 per cent [7].

The combination of acquisitions being based on motives of a non-strategic nature, together with payment of a substantial premium for the acquired company has, in many cases, led to unsuccessful acquisition results. The

[6] Austin, D. V. and Boucher, J. R., 'Tender Offer Update: 1982', *Mergers and Acquisitions*, Fall 1982, pp. 48–51.

[7] Prakash, J., *Acquisitions: Current Practice and Future Trends*, Research Report 655, SRI International, October 1981. For a discussion of disparities in asset valuation of acquired companies see Bradley, J. W. and Korn, D. H., 'Bargains in Valuation Disparities: Corporate Acquirer versus Passive Investor', *Sloan Management Review*, Winter 1979, pp. 51–63.

research results of studies on acquisition success and failure, and the vast number of subsequent corporate divestments in most advanced economies, are testimonies to the unfortunate record of much of corporate acquisition.

The decision to acquire a company should result from a well-developed corporate strategy. This article suggests approaching company acquisition from the corporate strategy perspective, one which should greatly enhance, but not guarantee, success in either an individual acquisition or in an acquisition programme.

Figure 1 outlines a strategic framework for acquisitions including the steps involved and their key components. The approach commences with a review of the strategic options which can lead to a decision to pursue an acquisition as a strategy. This is followed by a detailed analysis of the acquirer firm itself, and determination of the role acquisitions are to play for the company. These steps form the input to the development of acquisition criteria and subsequent identification and selection of industry sectors for detailed examination. This in turn leads to the screening and ultimate selection of acquisition targets. The final step is concerned with making the acquisition work through the integration of the acquirer and target company. This strategic framework for acquisitions is divided into seven discrete steps, each of which is examined.

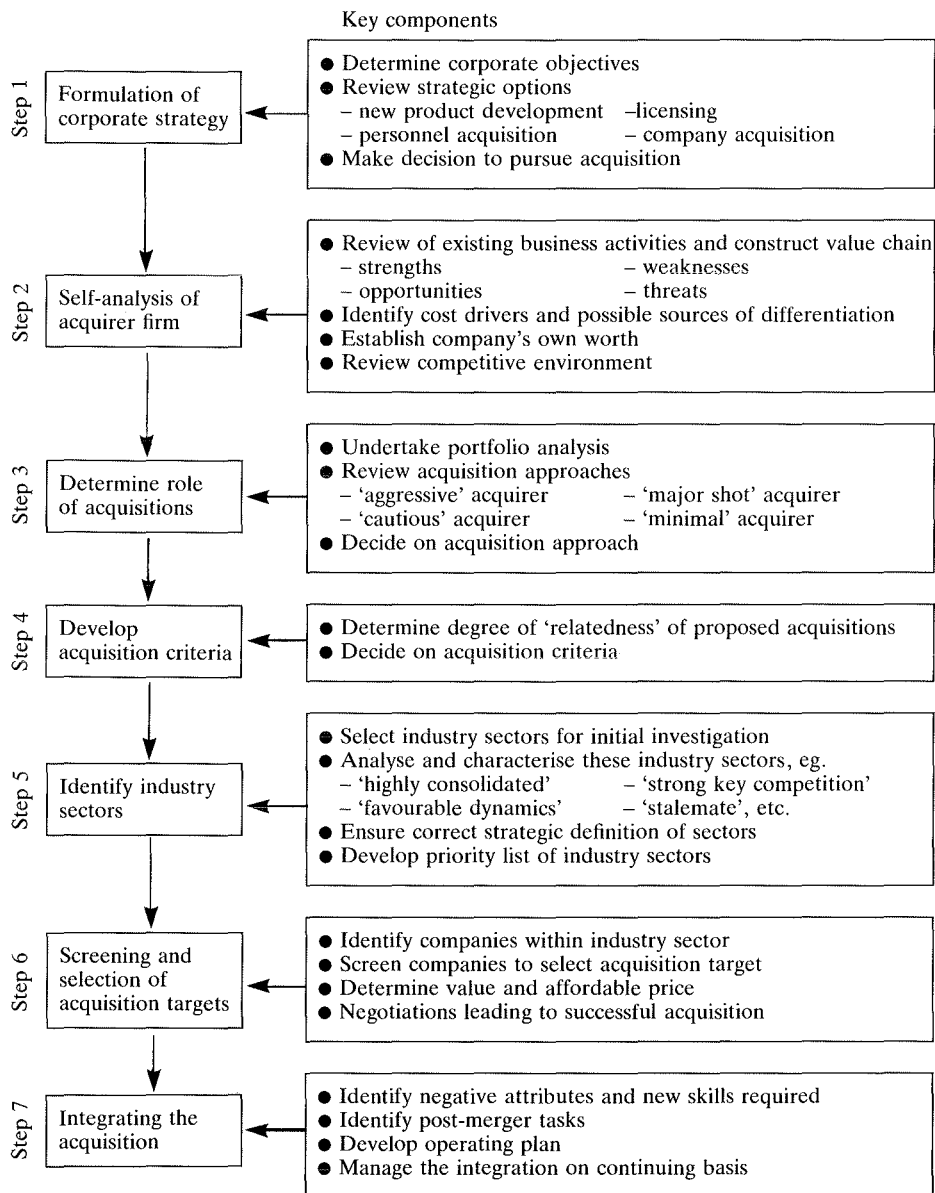
Step 1: Formulate corporate strategy

A decision to pursue acquisition should be based on a determination of company objectives which forms part of the process of formulation of corporate strategy. Corporate strategy is concerned with creating and protecting shareholder wealth. Shareholder wealth is generated by the spread of returns that are earned by a company in excess of the cost of capital. Parsons [8] shows that this 'spread' between the returns that are earned and the cost of capital is primarily a result of growth in equity, return on sales, and asset return. It is in this context of shareholder wealth creation that an acquisition strategy should be considered.

The justification for paying a price for an acquisition greater than that assigned to it by a well-informed market, is that economic synergies are gained as a result of the acquisition. Such an acquisition is one where the acquiring company adds value to the acquired company, and vice versa, to

[8] Parsons, A. J., 'The Hidden Value: Key to Successful Acquisition', *Business Horizons*, March–April 1984, pp. 30–37.

Figure 1. A strategic framework for acquisitions



an extent where the long-term economic value of the acquired company, in present terms, exceeds its purchase price.

Whilst some corporate bargains may be uncovered over time by the astute analyst, consistently finding such bargains is unlikely. The reason for this is obvious – considerable attention has been directed for many years across the entire corporate sector, for undervalued companies with growth potential or companies with potential for asset stripping. In a relatively efficient market, one which has been subject to considerable attention by many companies seeking acquisition prospects, attention should be directed at developing and building economic synergies rather than bargain hunting.

Acquisition decisions usually relate to a decision to expand or diversify, at least in the broader sense of the word, even if only to diversify in terms of market coverage by acquisition of another company in the same business (sometimes described as a horizontal merger). However, the decision to acquire a company is only one of a series of strategic options facing a company deciding to expand or diversify. These options include:

- new product development
- licensing
- personnel acquisition, and
- company acquisition.

Before making a decision to pursue company acquisition, a company should consider the relative merits of each of these options. Industrial Market Research Limited (IMR) have described the advantages of these options [9]. New product research and development is the slowest and has the highest risk, but is probably the most profitable form of diversification, if successful. However, few companies possess research and development facilities which can satisfactorily operate outside their existing business activities. Consequently, this option is most likely to be used for diversification into closely related business areas where a considerable amount of time is available for development.

Licensing is a relatively quick form of market entry. Its drawback is that the licensing fees can turn above average profits into average profits, or average profits into below average profits. Such an approach to diversification should preferably be carried on in conjunction with new product development so that a series of oncoming products will be available in the years ahead.

[9] Industrial Market Research Limited, *Planning a Diversification Strategy*, (London: IMR Ltd., Second edition, 1978).

Many businesses today are primarily reliant on personnel for success. The acquisition of personnel in certain markets, for example several of the high technology industries, enables market entry fairly rapidly without extensive research and development activities.

A company should carefully review the first three alternative strategic options above prior to considering acquisition as a means of diversification. Such a consideration is important as it is unusual for companies to be found which have a particularly successful record of trading activities in an existing market area and which, at the same time, are attractive to purchase. Thus, if acquisition is the strategic option decided upon it is essential to ensure that economic value can be added as a result of the acquisition.

Step 2: Analysis of acquirer firm

At this point we will assume the company has considered these strategic options and has decided upon acquisition. Given the characteristics of potential acquired companies outlined above it becomes essential to start to consider how we can add value and gain synergy.

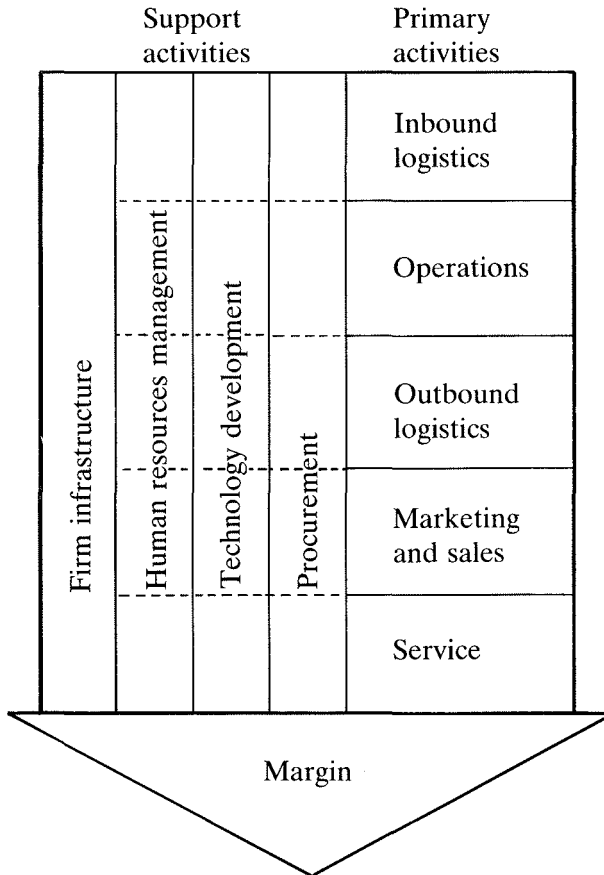
The process commences with gaining an understanding of the business through an analysis of its strengths, weaknesses, opportunities and threats. The focus should be done on identification of key strengths of the parent firm's existing business. To consider the strengths of a business, its activities should first be divided into the various steps of value added. Porter's value chain, shown in Figure 2, is an excellent means of doing this. Identification of the value chain for a business helps understand the relative importance of the constituent activities by dissecting the business into activities which are of significance from a strategic perspective [10].

Value chain activities can be categorised into two types – primary activities (inbound logistics, operations, outbound logistics, marketing and sales, and service) and support activities (infrastructure, human resource management, technology development, and procurement). The support activities 'cut across' the various primary activities within the firm.

It may also be useful to further subdivide specific activities within the value chain. For example, the marketing and sales activity in Figure 2 can be expanded further into constituent activities of marketing management, which include advertising, sales force administration, sales force operations, and promotion.

[10] Porter, M. E., *Competitive Advantage*, (New York: Free Press, 1985), pp. 33–61.

Figure 2. The Porter Value Chain



The objective of strategy is to create increased shareholder wealth through the development of a sustainable competitive advantage. A firm can possess or develop two types of competitive advantage – cost advantage or differentiation. Each element of the value chain should be investigated thoroughly to identify existing or potential means through which the firm can achieve cost advantage or differentiation as a result of acquisition. Figure 3 provides an illustration, based on IMR [11], of some typical sources of company strengths in three areas of the value chain – operations, marketing and sales, and technology development. These should be viewed as skills which may be transferable to an acquired company.

[11] Industrial Market Research Limited, op. cit.

Figure 3. Examples of company strengths for specific elements of the value chain

Operations

- Product and process patent protection
- Unique process know-how
- Unique machinery, parts, supplies, rentals
- Unique efficient manufacturing control

Marketing and sales

- Pioneering a major position
- Capture of leading distribution channels
- Unique customer services, personal selling, executive selling, applications engineering
- Unique marketing techniques

Technology development

- Unique research and development skills
- Consistently successful new product development

The extent of this internal analysis will vary depending on the nature of the acquiring firm and how far it decides to depart from its existing business. If such a move is a purely investment acquisition an in-depth analysis may not be necessary. However, for a strategic acquisition it is an important, but often neglected, step in the acquisition process. The following discussion is principally concerned with the approach to strategic acquisitions.

Once the acquiring firm has made an analysis of its own value chain it should then proceed to two further tasks. These include the establishment of the company's own worth and a review of the environment in which it is operating. Determining the company's own value in the context of the acquisition market takes on special significance for several reasons [12]: it places a value on the acquiring company (who might itself be vulnerable to a potential takeover); it can call attention to strategic divestment opportunities (such a divestment might improve the financial base of the company and, at the same time, alter the nature of subsequent acquisitions); finally, it can

[12] Rappaport, A., 'Strategic Analysis for More Profitable Acquisitions', *Harvard Business Review*, Vol. 57, No. 4, 1979, pp. 99–110.

provide a guideline to the 'cash versus exchange of shares' package that is ultimately offered to the prospective company who it wishes to acquire.

The company should also review the competitive environment in which it is operating and look at its financial position in terms of alternative economic and competitive scenarios. A fairly frequent problem source is downturns in an acquiring company's own economic fortunes which impair an otherwise sound acquisition programme. A careful consideration of the existing and future environment can reduce the possibility of such problems. Porter's framework for industry analysis [13] provides a useful framework for undertaking this task.

Step 3: The role of acquisition in the company

Once the company has undertaken an internal analysis of itself, it is then in a position to make a decision on what role acquisitions will play for the firm. The approach here will depend on the size and complexity of the company's operations. For multi-business firms a portfolio analysis of their constituent businesses should be undertaken to help understand the role acquisition might play as a part of the company's overall strategy. It should be the objective of any such multi-business firm to have a 'balanced portfolio'. This occurs when sufficient cash is generated from strong mature businesses to fund the investment required in growth areas. An imbalance occurs when insufficient cash is generated to fund growth opportunities, or there are insufficient growth opportunities to absorb the cash generated.

The role of acquisition should be considered in the context of the company's portfolio and, in particular, the competitive position and cash flow characteristics of each existing business. Pappas [14] has outlined the two possible positions that acquisitions can play if an acquisition strategy is an appropriate means of growth for the company:

- To strengthen the corporation's competitive position in a specific business.
- To enhance the overall portfolio by investing the excess cash generated by mature stable businesses in other businesses with prospects for long-term success, or acquiring a cash producer to fund growth opportunities.

The notion of strengthening an existing position is easily understood and the value chain approach described previously outlines a framework useful for

[13] Porter, M. E., *Competitive Strategy*, (New York: Free Press, 1980), in particular see Chapter 1.

[14] Pappas, G., 'Using Acquisitions to Implement Corporate Strategy', Paper presented to the IIR Seminar on Takeovers, Mergers and Acquisitions, Melbourne, May 22, 1984.

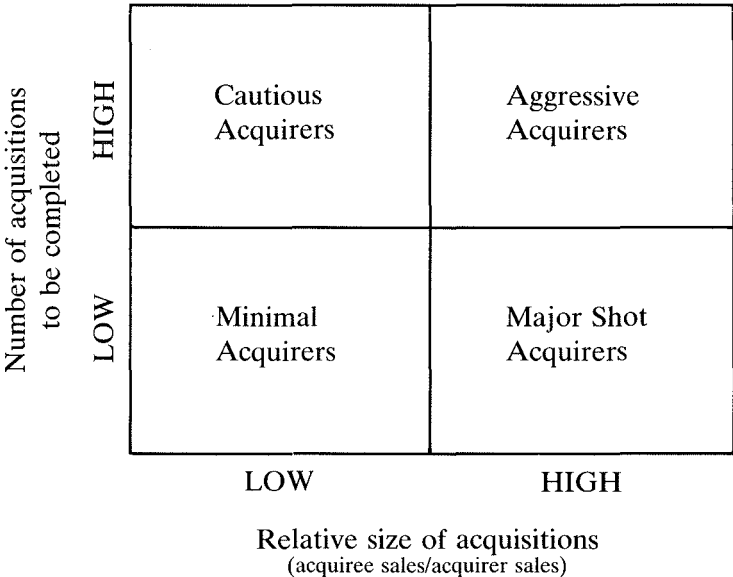
helping identify strengths to build on and weaknesses to remedy. Acquisitions aimed at industry rationalisation are often examples of this.

If a portfolio is comprised largely of businesses generating excess cash, it may be desirable to use these funds to acquire new businesses. Alternatively, if a company has a large number of investment opportunities but does not have the cash flow to fund them, then the purchase of a cash generating business can be one means of acquiring a future source of cash flow to allow exploitation of these investment opportunities.

Once the fundamental strengths and weaknesses of the business have been identified within the context of its value chain, and an understanding has been reached with regard to the portfolio balance, the firm is then in a position to make a decision as to what role acquisitions should play in its activities. Based on an approach by Burgman [15], Figure 4 shows the range of acquisition roles that can be adopted by a company:

- The company wishing to undertake many large acquisitions can be characterised as an ‘aggressive acquirer’

Figure 4. Alternative acquisition approaches



[15] Burgman, R. L., ‘A Strategic Explanation of Acquisition Success’, unpublished Ph.D. Thesis, Purdue University, 1983.

- The company which purchases many small firms and avoids placing too much of its funds into any one acquisition is a 'cautious acquirer'
- The company who seeks to purchase one large company (or a very small number of them) is a 'major shot' acquirer, and
- The company who plans to purchase one or two very small acquisitions is a 'minimal acquirer'.

The procedure of formulation of corporate strategy and self-analysis by the acquirer firm (including a review of its portfolio), should then logically lead to selection of one of the four approaches to acquisition shown in Figure 4.

Step 4: Develop acquisition criteria

Prior to developing their acquisition criteria, companies who have had little experience in acquisition may be interested in considering some relevant research findings. In particular, research into firms with experience in acquisitions in areas not closely related to their existing businesses is of interest.

Rumelt examined eight different degrees of corporate diversification [16]. These ranged from the 'single business' (in which at least 90 per cent of the revenues were derived from one source) to the 'unrelated portfolio business' (which consisted of many unrelated businesses, none of which contributed more than 45 per cent of total revenues). During his studies Rumelt identified that the best overall performance was achieved by 'dominant constrained' and 'related constrained' businesses. These were businesses with between 30 and 70 per cent of revenues derived from businesses that shared or drew upon core corporate resources and skills. He also found that businesses with at least 70 per cent of revenues from 'related/linked' businesses turned in above-average financial performance.

Research by Dundas & Richardson is also relevant. They examined the performance of a number of companies following a conglomerate, or unrelated product, strategy [17]. They concluded that conglomerate diversification can be successful but only under certain circumstances. These include: (i) the high performing conglomerates restrict their operations

[16] Rumelt, R. P., 'Corporate Diversification Strategies and Financial Performance', Managerial Studies Center, Graduate School of Management, UCLA, 1977.

[17] Dundas, K. M. M. and Richardson, P. R., 'Implementing the Unrelated Product Strategy', *Strategic Management Journal*, 1982, Vol. 3, No. 4, 1982, pp. 284-301.

to only three or four major business categories with broadly similar performance criteria; (ii) subsidiaries that account for more than 30 per cent of the total corporate portfolio are generally avoided, thus helping to spread the risk; (iii) major businesses that are acquired must be, or have the potential to be, product leaders in their industry or market segment; (iv) the operating divisions should be wholly owned; and, (v) moves into unrelated businesses will be better achieved through acquisition rather than internal growth.

They also found that the corporate office of such firms was small and had very little operational involvement. Also, the operating units were kept strictly independent. Finally, corporate management could play an important role in ensuring highly effective management was at the top of the acquired company. They quote one corporate executive on this point: 'Our role is to ensure that the quality of management in the divisions is better than it would be if we were not here'. They conclude that this feature, when exhibited by successful non-related product strategies, reduces the non-systematic risk compared with that experienced by share market investors.

These conclusions suggest that, at least initially, a company should consider diversification through acquisition in an area close to its existing business. Conglomerate diversification can be successful for those small number of firms who appear to identify the key combination of factors which are required in order to implement non-related product strategies. It should, however, be realised that numerically such firms who are successful are a small minority. Only if no opportunities relating to the existing business are identified should the decision be made to diversify beyond the business area.

Once a decision has been made on the degree of relatedness to be pursued, the acquisition criteria can then be developed. Acquisition criteria define the boundaries around which industry sectors and individual potential acquisition candidates are to be evaluated. It is essential that these criteria are carefully developed; they should not be too narrow or too broad. If they are too broad the firm can be faced with an enormous number of industries and firms to evaluate. This can place an enormous task on the company overburdening it during the screening process. On the other hand, the criteria should not be so narrow as to exclude valid and sensible acquisition sectors and candidates within them. Albert provides an example which highlights the danger of making acquisition criteria too rigid or idealistic where the acquisition criteria were so ideal the 'key elements were on the verge of being mutually exclusive. The client was unwilling to modify the criteria and insisted that they be rigidly applied. The result, of course, was

that we rejected all possibilities. No acceptable acquisition candidates could be identified' [18].

The statement of acquisition criteria will be dependent on the role that the acquisition is to make in the context of the corporate strategy of the firm. Whilst it is difficult to generalise about what should be covered under the heading of acquisition criteria because of the vast differences in acquiring firms and the objectives of their acquisition strategies, in general, the following factors should be considered:

- size of investment
- type of technology
- industry focus
- stage of industry evolution
- synergy between acquirer and acquiree
- management predisposition
- cash flow and profitability
- geographic location
- market position
- competitive dynamics
- management skills
- strategic fit.

At this point the acquirer company has determined the role of acquisitions in its corporate strategy and should now set down its acquisition criteria. Once this is completed, it is now in a position to identify which industry sectors it should examine for acquisition candidates.

Step 5: Identification of industry sectors for examination

The starting point of identification of industry sectors for a large multi-business firm is to look at the whole range of the economy. Taking the standard industrial classification, the acquisition criteria are considered as filters to exclude those industry sectors which are not appropriate to the firm's strategy. The following discussion is based on the type of analysis that

[18] Albert, K. J., 'Acquisition Candidates: How to Analyse Them', Chapter 7 in Albert, K. J., (Ed.), *Handbook of Business Problem Solving*, (New York: McGraw Hill, 1980), pp. 18.1–18.16.

might be undertaken for a large firm with a wide perspective on possible acquisition activity. A smaller firm with limited resources would need to adopt a more focused approach.

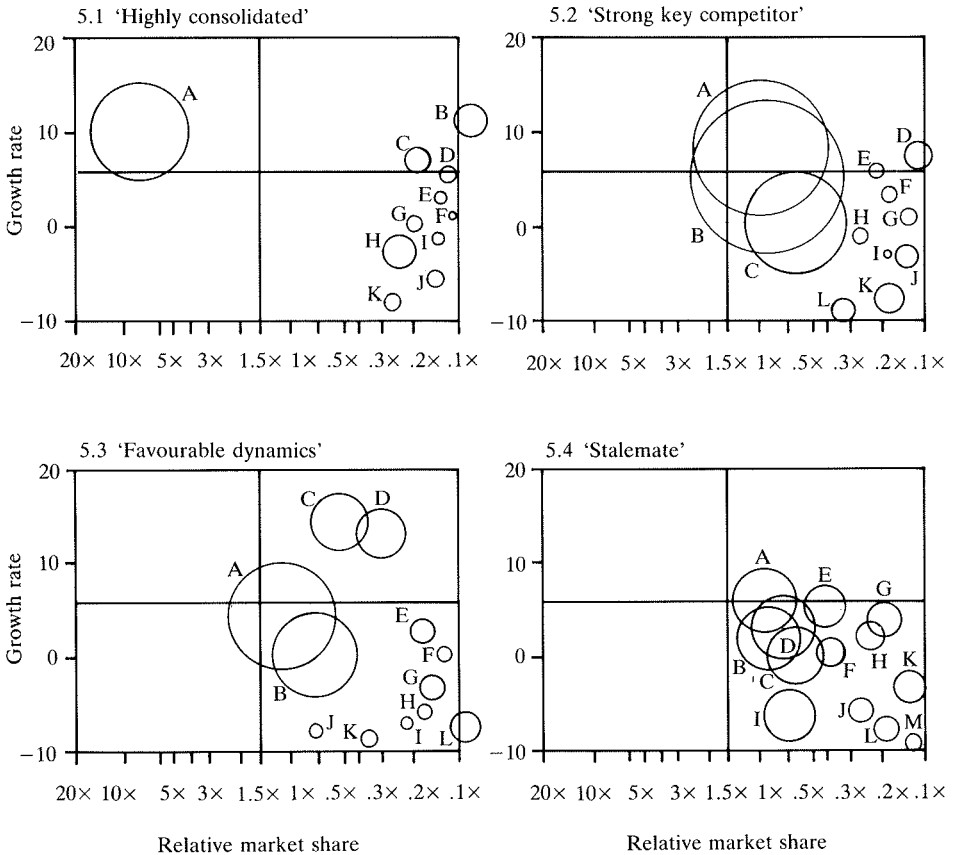
Each industry sector can be examined using the sector graph approach. This is a variant of the product portfolio display and was developed by Braxton Associates to aid in the screening of suitable sectors. The sector graph approach is shown in Figure 5 and is used to help analyse the competitive dynamics of the industry sector under consideration. Because search and evaluation of acquisition candidates from a wide range of industry sectors is costly, the sector graph is a useful tool for taking a 'first cut' at analysing the industry sectors. Figure 5 shows four illustrations of different types of industry sectors based, in part, on Ebeling & Doorley [19]. They include examples of a 'highly consolidated' industry sector, a 'strong key competitor' industry sector, a 'favourable dynamics' industry sector, and a 'stalemate' industry sector. Companies using this approach may wish to develop further categorisations to suit their own needs.

The first sector graph, 5.1, illustrates a 'highly consolidated' industry sector. It shows Firm A as a dominant competitor having a very high relative market share and strong growth. The rest of the industry is characterised by highly fragmented competitors with very small relative and absolute market shares. A key market leader such as Firm A is in a strong competitive position and is not likely to be available for acquisition. Even if it is available, it is likely to be extremely expensive because of the dominant position it holds within the industry. On the other hand, the fragmented competitors may not offer much in the way of opportunity for the acquiring firm. Whilst one (or more) of these competitors may occupy a specialised market niche, Ebeling & Doorley argue that unless such a business sector is understood extremely well, searching for such a niche may be much less productive than examining other industry sectors which offer more promise. They point out that such a niche can be highly vulnerable because dominant firms often have the basic skills to compete in any segment of the market that emerges as an attractive one.

The second sector graph, 5.2, shows an example of a 'strong key competitor' sector. In this sector, no competitor has emerged as the dominant one. The leading firms, A, B, and C, are growing at the expense of the rest of the industry. Again, these key competitors are likely to be unobtainable (or if they are, they will be very expensive). The dominance of the key

[19] Ebeling, H. W. and Doorley, T. L., 'A Strategic Approach to Acquisitions', *Journal of Business Strategy*, Vol. 3, No. 3, 1983, pp. 284–301.

Figure 5. Illustrative industry sector characterisations



competitors suggests that unless part of your existing business value chain complements one of the smaller competitors so as to significantly enhance their combined position, or your existing business activities and skills could be used to reverse the unfavourable growth characteristics of the smaller firms, this industry sector should probably receive low priority in any further investigation.

The third sector graph, 5.3, depicts one which has favourable competitive dynamics. In this sector, no firm has reached market dominance and A and B, the largest two firms in the industry, are losing their market position slowly. By contrast Firms C and D are growing strongly and could overtake

A and B if strong growth continues. From the perspective of competitive dynamics, Firms C and D may appear good potential candidates for possible acquisition.

A further example is shown on the fourth sector graph in 5.4. Here a 'stalemate' position has developed with none of the firms having emerged as a leader. Such industry sectors need to be examined closely to ascertain if a competitive advantage can be identified to unlock this stalemate position.

The preceding discussion does not suggest that those sectors which have been characterised as less promising ones should be disregarded completely, rather that in the 'first cut analysis' of possible sectors, it would appear to be more productive to attempt to identify industry sectors which seem to have more promising competitive dynamics.

A further point of importance in any such analysis is the need to correctly define industry sectors. Whilst the standard industrial classification system used in most developed economies is a useful one for considering the full range of industries that make up the economy, it is essential that the industry is defined from a strategic perspective. This strategic perspective must take into account an industry definition that allows defensible competitive advantage to be clearly assessed. The skills required to defend a competitive position with, for example, the printing industry could vary considerably. Printing on fabric versus paper, or publishing books versus periodicals, reflect significantly different sectors and an appropriate level of subdivision must be undertaken that reflects useful competitive boundary definitions.

Two further considerations are important. Firstly, we must consider what geographic boundaries should be drawn around the industry sector. Should the business sector be seen as regional, national or global in orientation? For example, many service businesses, by their very nature, are regional or national. Other business sectors cannot be considered separately from the context of global competition (for example, manufacture of television sets). The second consideration is that whilst participation in an industry sector, in total, may be excluded, a degree of participation in some activity within the value chain of that industry may be possible. For example, the mining industry which requires hundreds of millions of dollars investment to be a major player, may provide opportunities for a more limited participation – perhaps as a service provider or equipment supplier within that industry.

It is clearly not practical for any firm to undertake a detailed analysis of several hundred classes of industry in their search for acquisition possibilities. However, in most cases, large sections of the economy may be excluded because of the constraints decided upon when formulating the acquisition criteria. The extent to which a firm will select industry sectors to consider

will depend very much on its size, capabilities, resources and strategic objectives. Ebeling & Doorley suggest, in the context of a large firm, that 40 or 50 initial sectors might be considered and that these should be filtered down to half a dozen or so with favourable competitive dynamics. (Smaller firms may need to consider 15 or so initial sectors and filter these down to 3 or 4). These half dozen sectors, and the companies within them form a priority list which can then be examined in great detail.

Step 6: Screening and selection of possible acquisition targets

This stage of the acquisition process starts with the identification of companies within the industry sector selected. It then continues with the screening and selection of alternative acquisition candidates. It concludes with the development of a negotiation plan which, if successful, leads to the purchase of the target company.

The initial task is concerned with the identification of companies within the selected industry segments. If the 'sector graph' approach we described previously has been used, the principal companies in the sector, in terms of their size and growth, will already have been identified. Organisations offering computerised search facilities in this area, use of trade directories, and corporate advisers such as lawyers, accountants, management consultants and investment banks, can enable such lists to be prepared fairly quickly.

The company will already have developed its acquisition criteria and can undertake an initial screen to filter out those companies which do not meet its criteria. It is at this stage that the remaining acquisition candidates should be subject to a rigorous business analysis. This step should involve an analysis of their competitive position, industry trends, and the structural position of the firm within their industry sector, prior to the necessary financial analysis and assessments. An integral part of this analysis should be a comparison of the value chain of the acquirer firm with that of the acquisition candidate, as shown in Figure 6. This comparison should show where the real potential for value creation through synergy exists. The focus here should be on determining a basis for competitive advantage in terms of cost and differentiation. This implies being able to identify what is important to long-term profit potential in an industry segment and being able to take advantage of it through the appropriate choice and integration of the acquisition prospect. The acquisition targets selected should result from the

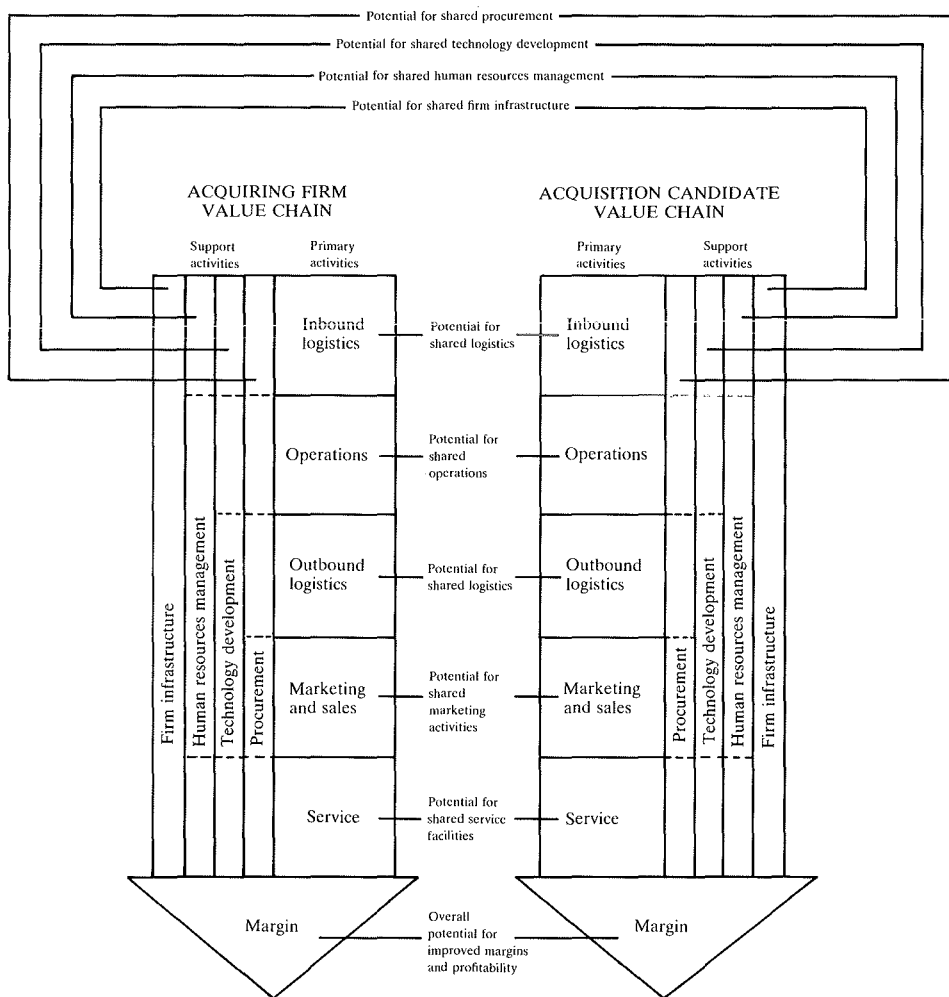


Figure 6. Identifying synergy potential between acquirer and acquisition candidate

identification of candidates with the greatest potential to increase and protect shareholder value for the firm.

Once businesses that are attractive from a strategic perspective have been identified, the question of their ownership should be addressed. In a business

where ownership is closely held, an approach can be made directly to the owners. In the firm where ownership is widespread, a public offer can be made for the shares. Generally, this is more time consuming and costly than a direct approach. Often desirable businesses are not directly available through these approaches as they are owned by larger multi-division firms. In many instances, the possibility of acquiring such businesses is automatically rejected. Such rejection is not always appropriate as it is sometimes possible to purchase such a subsidiary through negotiation with the management of the multi-division firm. Even if such a multi-division firm is not currently interested in selling, opportunities may occur, over time, for their purchase. Such opportunities may occur where a company that was a good fit in its parent's overall portfolio is no longer a good fit (General Electric's divestment of Utah to BHP is a good example of this), or where the multi-business firm goes through a period of poor performance, or loss, and may be amenable to selling a subsidiary to realise a fast injection of needed capital.

The astute corporate acquirer will examine the role of a desired subsidiary in their respective parent's portfolio, and gain an understanding of the parent's overall strategy. If the possibility of future acquisition exists, the environment of the subsidiary and the parent should be monitored on an ongoing basis. For example, United Technologies maintains a dossier on some 50 attractive acquisition candidates that fit its future acquisition plans [20]. The notion of a 'strategic window' can be used to prepare for and plan the appropriate timing and negotiation strategy with which to approach the parent company's management.

Once the target acquisition company (or companies) has been identified, the next activity is to determine the value of the acquisition and the price that can be afforded. Whilst most companies are available for purchase if a high enough price is offered, the key is to ensure not too much is paid for the acquisition. If it is a listed company and the asking price is greater than the value assigned to it by the stockmarket, the acquirer must determine if the price exceeds the value of the business to him. Appropriate questions to consider are: what is the maximum price that should be paid for the target company?; what are the principal areas of risk?; what are the earnings, cash flow and balance sheet influctions of the acquisition?; and what is the best way of financing the acquisition?. These questions are raised by Rappaport

[20] Willensky, D. R., 'Making it Happen: How to Execute an Acquisition', *Business Horizons*, March–April 1985, p. 42.

[21] who outlines the financial evaluation process for answering these questions.

The acquisition process now moves to the development of a negotiation plan. In a sense, this stage of the acquisition process is more tactical than strategic. MacDougal & Malek provide details of a good analytic approach which can enable a potential acquirer to develop a competitive edge in acquisition negotiations [22]. In discussing the two common obstacles to successful negotiation – the inability to settle on a realistic price and the failure to sell the seller – they conclude that three steps are essential to place a potential acquirer in a position of genuine advantage: (i) the potential acquirer should learn more about the seller's business than other prospective acquirers, and thus identify specific business advantages and bring them into the negotiation discussions; (ii) the potential acquirer can develop a combined growth plan that will capture the imagination of the seller and lessen the likelihood of major disagreements arising over minor terms of the agreement; and, (iii) by increasing the chief executive's personal involvement and ensuring frequent informal contacts with executives of the acquisition candidate, it can develop the sound personal rapport that is a prerequisite to a successful working relationship. MacDougal & Malek also provide useful insights into the planning of such negotiations.

Step 7: Integrating the acquisition

Once the final decision to acquire a company has been made and the ensuing negotiations have proved successful, the strategic focus changes from identification of the acquisition candidate and successful negotiation of its purchase, to the integration of the acquired company.

The degree of attention that is needed to be directed at the acquisition will depend upon the nature of the acquisition. As noted earlier, we are primarily concerned here with strategic acquisitions – the situation where economic value and synergy should be realised as a result of the acquisition. For such an acquisition, the successful integration of an acquired firm becomes of prime importance. When such integration is considered, management often focuses on a limited number of issues such as those dealing with the acquisition's strategy, the re-organisation of its structure,

[21] Rappaport, A., op. cit.

[22] MacDougal, G. E. and Malek, F. V., 'Master Plan for Merger Negotiations', *Harvard Business Review*, January–February 1970, pp. 71–82. See also Willensky, D. R., op. cit.

and re-aligning the systems of the acquired company to match those of its new parent in the form of an operational plan.

However, one of the principal conclusions from a recent survey on mergers and acquisitions undertaken by Egon Zehnder International was that management should spend as much time evaluating the soft aspects of a potential acquisition as they spend on the more tangible assets [23]. Accordingly, broader issues need to be addressed.

Work undertaken by McKinsey & Co. suggests that a consideration of a range of factors is appropriate. The McKinsey 'Seven S' model [24] is a powerful device for considering a change program within any organisation and is particularly appropriate in a considering integration of an acquisition. The seven elements of the framework – strategy, structure, systems, style, skills, staff and shared values are used to consider the fit between acquirer and acquiree companies. This model can be used to identify the positive attributes possessed, the negative attributes and the new required skills that need to be developed. A careful consideration of all these seven S's – not just strategy, structure and systems – can help to ensure the successful integration of the acquired company into the acquiring company system. At the same time, it should be recognised that the acquiring company may well have to go through some process of change itself. It is essential that there is a high degree of 'fit' between each of the seven elements and that they are aligned in the same direction in which the industry environment will be moving in the future.

The examination of each of these seven elements draws our attention to the need to focus on the behavioural aspects of integrating acquisitions. Regardless of whether this framework or other methods are used, the importance of this matching and integration process cannot be over-emphasised. The poor overall record of acquisition activity would suggest that many acquirer firms are better at acquiring than managing their acquisitions. The cost of mismatch is very high in terms of both the bottom line and the amount of top management time that can be diverted from the established business activities.

Out of these considerations for matching, an operating plan should be devised which ensures the integration of the newly acquired firm. A significant number of tasks have to be undertaken in bringing about the integration of acquirer and acquiree firms. Shrallow suggests that such a plan

[23] Koblentz, J. M., 'The Value of Management Capital in Mergers and Acquisitions', *Corporate Issues Monitor*, Vol. 1, No. 2, 1986, pp. 1-4.,

[24] Waterman, R. H., Peters, T. J. and Phillips, J. R., 'Structure is Not Organisation', *Business Horizons*, June 1980, pp. 14-16.

should identify the management team, the way in which operations are to be carried out, the nature and degree of any special support to be provided, financial goals to be attained, and performance objectives by market, customer and product [25]. This operating plan should be supported by the strategies and procedures by which these goals and objectives are to be carried out and have provision for the integration of any functional activities and systems of the acquired firm. The overall objective of the operating plan should be aimed at preservation and enhancement of the vitality and strength of the acquired operation through the continued goodwill and commitment of all managers and key employees of the acquired firm. Shralow concludes that a key to achieving success is to ensure that the acquirer's management resist the temptation of looking beyond the current acquisition to the next one, thus neglecting the existing task of integration. Managing the integration of a newly acquired company should remain an ongoing activity of high priority once the acquisition is made.

Summary

An examination of the overall record of acquisition activity suggests that improvement in acquisition success could be made through a more strategic approach to acquisitions. Acquisitions should be seen as a *part* of a company's corporate strategy aimed at increasing and protecting shareholder wealth. Companies who acquire firms should be clear about the strategic direction to be followed and the role the acquisition is to play in its overall strategy.

Companies which are acquired as an *investment* acquisition should be left with maximum independence. Those which are *strategic* acquisitions, should be carefully examined and plans made to ensure synergistic benefits are achieved by the appropriate match between the parent firm's value chain and that of the acquired firm. A planned approach that focuses on competitive dynamics, rather than past performance, is more likely to ensure future profitability.

The preceding discussion is not meant to imply that a highly mechanistic process involving long lead times is a necessary prerequisite to all acquisition activity. Rather that over a period of time an approach that is based on the

[25] Shralow, D. A., 'Managing the Integration of Acquired Operations', *Journal of Business Strategy*, Vol. 6, No. 1, Summer 1985, pp. 30–36. Also see: Searby, F. W., 'Controlling Postmerger Change', in Mann, R. (Ed.), *The Arts of Top Management*, (New York: McGraw Hill, 1971), pp. 12–21.

Careful analysis of the underlying strengths of the acquirer company and the identification of acquisition candidates which meet the chosen criteria, and can provide a good match in terms of the seven elements of strategic fit, is a more appropriate approach than the unstructured approach that still characterises much of acquisition activity today.

At the same time, there is a need for companies to be opportunistic with regard to acquisition. When a strategic window opens and a unique opportunity presents itself, it is not the time to become 'a prisoner of the scientific method'. A recent acquisition opportunity, with which the author is familiar, highlights the need for fast response. Of the two firms who were interested in the potential acquisition, the unsuccessful firm managed with great difficulty to organise a meeting of its board of directors, which was to be held in four weeks' time, to be moved one week earlier. The successful firm organised a board meeting within three days! This involved five executives, who were overseas at the time, returning immediately to attend the meeting. Speed of response, the assumption of commercial risk and a recognition that the purpose of corporate procedures should be aimed at assisting rather than inhibiting the organisation are also necessary attributes in acquisition success.